

Contractual Relations: It takes both trust and lack of mistrust

Siegwart Lindenberg

ICS, Dpt. of Sociology
University of Groningen
The Netherlands

Why is contracting an interesting phenomenon to study? As with most important phenomena, there are various good reasons and many of the arguments brought forth and the aspects that are being considered will depend on the particular reason one studies contracting in the first place. Failure to realize these differences can create unnecessary confusion about what is being claimed. The biggest difference in the way questions are asked is between (neo-classically steered) normative and (not necessarily neo-classically steered) descriptive puzzles. **Normative puzzles** can arise when observed contracting is not as expected by neoclassical theory (say, there is under-investment or even failure to contract at all when potentially profitable projects arise). In the neoclassical apparatus, such imperfections must be the consequence of an imperfectly institutionalized market. The first question that emerges in this context is whether welfare reductions that follow from imperfect contracting are due to monopolistic opportunities, i.e. due to deficient institutions that govern competition. The answer to this question might be (and has been) that, besides imperfect competition, there are reasons why contracting is bound to be less than perfect, such as information costs and limitations in the verifiability in court. Then a new normative puzzle comes to the fore (see Richter 2000): can the imperfections that arise from these limitations be more or less compensated by different kinds of contracts? What would the optimal contract (within the neoclassical framework) look like under such conditions? Are the conditions for writing such a contract easily met or are they prohibitive?¹ Would additional institutional arrangements (say, concerning property rights or the functioning of the courts) be necessary for such contracts to be written? Richter (2000) has described such efforts in some detail.

Descriptive puzzles in the field of contracting are mainly of three (often interrelated) kinds:

- (a) Why are there so many different kinds of contracts?
- (b) What are the non-contractual safe-guards (or governance structures) surrounding different kinds of contracts?
- (c) What does an entire contractual relationship look like, including **ex ante** and **ex post phases**, what role does a written contract play in this relationship, what role do other governance arrangements play in this relationship and how can these things be explained?

These puzzles arise not from the confrontation of neo-classical theory with contrary empirical cases. Rather, they arise from a substantive interest in the explanation of institutions and the way they work. Macneil's (1978) empirical study of (changes in) contract law and concomitant governance instruments is a case in point.

For addressing these kinds of puzzles, the neoclassical apparatus may or may not be adequate. In any case, the theory used to address these puzzles must itself be descriptive rather than normative and thus it should include all relevant human proclivities (if any)

irrespective of whether or not they fit the neoclassical apparatus.² Normative questions can arise on the basis of answers given to these descriptive questions. For example, one might ask what institutional arrangements are needed to support a contractual relationship over time. But these normative questions are not driven by the normative use of the neo-classical apparatus. For the same reason, the issues that are central to the descriptive questions are different. Contrary to the neoclassical normative context, the empirical context of these descriptive puzzles gives a central place to issues of trust and cooperative behavior in long-term relationships.

In the following, I would like to address puzzle related to (potentially long-term) contractual relationships and the issues of trust that go with it. Anticipating the result, I will come to the conclusion that building and maintaining trust is necessary for such relationships but it is only possible if mistrust is reduced beforehand. The instruments for the reduction of mistrust are different from those that build and maintain trust. In the literature, we find two clearly separate streams of work: one seeing trust as a matter of calculated risk, the other as a relational issue. For example, Coleman (1990) has suggested to model "placing trust" as calculated risk in situations in which an actor has to act before he knows what his potential exchange partner is going to do (see also Dasgupta 1988). A person will place trust if and only if the expected gain from trusting is higher than the expected loss. In response, Williamson (1993) has plausibly argued that one might as well not burden the analysis with the extra term of "trust" since it is nothing but a calculated risk. Whereas this seems to be a matter of preference for a certain language, it does pinpoint the heart of this approach to trust: it is linked to situations in which people know the alternatives (otherwise they could not assign risks) and it considers relational issues only insofar as they are pertinent to the calculation of risk.

Many others have doubted that trust can be reduced to "calculated risk" even if there is "an element of calculativeness" or "instrumentality" involved. Noninstrumental aspects of trust concern mainly relational issues, such as social embeddedness, liking, and relational norms. "Instrumental models are inadequate to explain people's trust in others" say Tyler and Kramer (1996, p.6). Of course, relational issues may turn out to feed into calculativeness (for example, "social embeddedness" may create reputation effects)³ and vice-versa (for example, trust relationships may be engineered)⁴. But are there two kinds of trust? If so, how does each work? Do they have different preconditions? Are they dependent on each other? These and many other related questions cannot be answered at present with the given theories of trust.

Mistrust and the legitimacy of reactions

In order to facilitate the analysis, I will introduce a simple concept, well-known in the social sciences: the legitimacy of reactions. If I step hard on somebody's foot, he might cry out. This should not surprise me, nor should I accuse him of being over-sensitive. If I give somebody a thousand dollars as a gift, he may thank me. Again, this should not come as a surprise and I should not accuse him of being overly emotional. In both cases, the reaction of the other is "legitimate", it is what reasonable people in this group would find reasonable and/or common. Common understandings of how people feel, act, and react, given the habits and mores of this group, are enough for this legitimacy effect to occur. They create focal points (Schelling 1960) and no particular powers of farsightedness are necessary. This effect gives rise to an interesting phenomenon: when reactions are legitimate, they are relationally neutral, i.e. they don't say anything specific about the person who reacted because

any other reasonable person in his place would have reacted similarly.

Let me apply this concept of legitimate reaction to contracting with assumed self-interest and calculativeness. Take a scenario used by Williamson as example. There are two periods. In the first period, orders are being placed. In the second period, the production occurs dependent on demand realization. The buyer may confirm or cancel the order in the second period. If the supplier has no loss if the order is canceled, there is no problem. If he has to make a specific asset investment in the first period in order to produce in the second, he loses a certain amount if the order is canceled. Clearly, in that case, the supplier would like compensation (i.e. a hostage) to be agreed upon beforehand or else he will not make the specific asset investment. This is a matter of the distribution of risks: the supplier does not want to carry it all. If the buyer flatly refuses to share the risk, the case is closed. If he is willing to post a hostage, by his very act he removes the necessity to invoke any issue of trust. If, however, the buyer refuses to post a hostage but instead promises not to cancel the order even if demand is low, then a potential issue of trust is involved: will he or will he not keep his promise. A closer look convinces us that the supplier has good reason to mistrust the buyer simply because keeping this promise is against the well-understood self-interest of the buyer. Anybody with some experience of how people act knows that when a promise is blatantly against well-understood self-interest, there is good reason to assume that the promise will not be kept. The risk is thus easily assigned. In such situations, mistrust is legitimate and not a sign of ill will or abnormal risk-aversion. It is the legitimacy of mistrust that creates focal points for the solution and makes remedies relationally neutral. In other words, the mistrusting party in such a situation can claim the necessity of remedies, pinpoint a menu of solutions and show good faith at the same time.

Such remedies are likely to come from a menu of instruments and the accumulated experience within an industry (see DiMaggio and Powell 1991⁵). What these remedies will have in common is that they must reduce mistrust, that is, they must reduce blatant misalignment of incentives between the course of action promised and the course of action that would follow from self-interest. This has long been recognized in the literature, especially **incentive alignments via credible commitments**, be that on the basis of legal requirements or hostages, or through reputation effects, middlemen, delegation or other means.

Trust and radical uncertainty

As mentioned before, there is also the "non-calculative" side of contracting. Let me begin with an example. A supplier is faced with a sudden spell of high absenteeism and he is short of labor and in a rush because the product has to be shipped to his client. He could solve his time problem by skipping the rather laborious quality control. The quality control is not something the supplier and his client have put in the contract. There is thus no specific sanction in the contract for failing to conduct quality control. However, the spirit of the agreement implies that the price agreed upon is for a certain quality and so far things have been satisfactory for both parties. Clearly it would be against the suppliers longer-term interest to be unreliable with regard to quality control because the on-going relationship with the client would be strained if he were. But at this moment, it would be in the suppliers short-term interest to skip the control just this once and the client would have a difficult time proving that it had been skipped. The client trusts the supplier that quality control is performed.

How does this situation differ from the previous one? There is no legitimate mistrust in this situation. Longer-term and short-term incentives point in opposite directions and one cannot possibly speak of the supplier's blatant self-interest in not performing the quality control. Still, there is a short-term temptation to deviate from the agreement. The point is that the temptations to defect are random and that one cannot even come up with a reasonably exhaustive list in advance (let alone say something about the distribution of these events). Thus, it is not possible to assign risk to the various future temptations to defect. In this sense, there is radical uncertainty and it is this radical uncertainty that makes it impossible to reduce relational issues to the estimation of risk. In on-going relations, short-term incentives to cheat are highly situation specific. In one situation, time pressure might create a temporary incentive to compromise on quality control; in another situation, a new but demanding client may create an incentive to put running orders of old clients on the back burner; in yet another situations, the need for quick coordination prohibits the establishment of proper safeguards and thus creates temporary incentives for self-serving post hoc explications of highly implicit agreements. In such ongoing relationships there is no possibility to keep aligning the interests in order to neutralize temporary temptations, or to decide for every situation anew whether to trust or not to trust, or to have "stand in" partners just in case. **One party trusts the other if he believes that the partner's short-term temptations to defect do not lead to reductions in the partner's reliability.** The instruments necessary to achieve trust are different than those used to reduce mistrust. What is more, I will argue below that in order to start building trust, legitimate mistrust must already be strongly reduced.

Neoclassical theory and game theory can explain quite well the workings of mistrust once the fiction of full information has been dropped. Here, considerable theoretical progress has been made by exploring hostages, reputation networks, middlemen, control effects, information effects, and effects of the shadows of the past and future⁶. If, within the neoclassical framework, genuine trust problems can be separated at all from mistrust problems, they are likely to be treated as dispositional problems (type selection: trustworthy and non-trustworthy types). Within neoclassical theory and game theory, it is difficult to even recognize the distinction between mistrust and trust problems. The main reason for this, it seems to me lies in the fact that in order to focus on general trust problems, one has to go against two related central assumptions in both neoclassical theory and in game theory: farsightedness and rational discounting. First, for economists trained in neoclassical theory it is very difficult to let go of the assumption that basically all important things can be anticipated, that this ability is even part of the implicit definition of rationality. Williamson is an interesting case in point and his own development in this is telling. In 1975 he embraced the concept of bounded rationality, meaning by that that there are many contractual situations in which consequences of alternatives are difficult and at times impossible to estimate (see Williamson 1975, p.23f). Knight's adage that we should deal with "human nature as we know it" was then Williamson's battle cry against neo-classical theory. In 1985, he allowed that bounded rationality might be seen as a convoluted way of saying that information is costly (Williamson 1985, p. 46). In 1993, he came right out and stressed individual farsightedness as a basic assumption of rationality. Why? Because not to do so is too costly to him in terms of the tools he would like to use. "But for farsightedness, transaction cost economics would be denied access to one of the most important 'tricks' in the economist's bag, namely the assumption that economic actors have the ability to look ahead, discern problems and prospects, and factor these back into the organizational/contractual design." (Williamson 1993, p.129) In such a context, problems of mistrust can be analyzed but problems of trust cannot

even be formulated.

Second, for economists trained in neoclassical theory, it is also difficult to accept that the way in which people discount future events cannot generally be called rational. This is so even though there is overwhelming evidence for the fact that people are apt to let short-term aspects prevail over long-term aspects far beyond any degree that can be called rational in any meaningful way (see for example Loewenstein and Thaler 1989; Loewenstein and Elster 1992). Random shocks of short-term temptations derive their danger for contracting only from discounting that does not take long-term consequences into consideration. Thus, if this form of myopia is neglected, contractual problems that arise from it can also not be taken into account.

Relational aspects of trust can better be handled by motivational theories on preference formation, emotions, and attachment as springs of action. They have led to the consideration of organizational culture, of the importance of interaction frequency, of the shadow of the past ect. (see for example Rousseau 1995), but they cannot handle mistrust problems, cannot deal well with situational fluctuations in temptations to breach, and can say nothing about the possible interdependence between mistrust and trust problems.

Enter cognitive psychology: the concept of framing

It is the **cognitive** turn in psychology which has brought new tools for the analysis of trust. This "turn" has started already in the 1950s, but it has moved progressively toward studying processes that influence a person's attention. Attention is a scarce good and thus it is selective. What is being attended to is particularly important for determining the kind of action that is taken (see also Fazio 1990). Different bits of knowledge are mobilized, different categories activated, with the result that the individual is more sensitive to some kind of information than to another, relies more or less on stereo-types, place more value on certain outcomes etc. For example, individuals' negotiating behavior is affected by instructions that tell them to be cooperative or to be competitive (see Carnevale and Lawler 1986). Individuals can be **primed**, that is, certain stored knowledge, categories, or attitudes can selectively become more easily accessible thereby influencing a person's information processing (see Higgins and Brendl 1995). At the same time, aspects not belonging to the selected construct are inhibited thus creating a double selective effect (see Bodenhausen and Macrae 1998 and Houghton and Tipper 1996). Note that although these effects steer attention, they need not be conscious or work via prior intention. For example, a person in a situation in which others speak highly of the value of achievement can get "primed" to focus on achievement without being aware of it (see Bargh 1997). Most important for influencing a person's cognitive activity and thereby the action that is based on such activity are goals (see Gollwitzer and Moskowitz 1996). Recently, one prominent researcher in this field even claimed that 'most cognitive activity is goal dependent' (Kruglanski, 1996). As we will see, the link to the workings of trust is very direct. Goals can be influenced by the situation but they cannot be conjured up at will. At any given moment you have them or you don't. One might try to change one's goals over time but that takes a great deal of effort, if it works at all. One also might try to avoid situations that mobilize goals one does not want to have mobilized (such as staying away from the sight of food if you want to lose weight). If the contracts partner's goal is the preservation of a good business relationship **and** if his interests are not grossly misaligned with mine, he would reliably not pay much attention to short-term opportunities that would break our agreement. His information processing would automatically inhibit the

consideration of alternative belonging to contrary goals and enhance the consideration of alternatives that a goal congruent. Assume to the contrary that the partner had no such relational goal but wanted to make me believe he had such a goal. He then would have to deal again and again with the temptation to breach even if such a breach is against his longer-term interest. Chances are, he would succumb to many of these temptations. Faking to have a goal takes much effort because goals are so influential on cognitive activity. In order to flesh out this argument, we have to go into some more detail about this cognitive extension of rational choice theory.

What we need is a model that links these insights from cognitive psychology to a theory of rational action. For some years now, such a theory has been developed under the label of "framing"⁷ (see Lindenberg 1988, 1993). The basic idea is as follows. In human cognition, entities (goals, things, words, meanings, aspects, characteristics, relations etc) can be in the foreground or in the background. What is in the foreground (called "the frame") is analyzed and attended to in more detail than what is in the background and, even more important, it is analyzed in terms of what is in the foreground. Therefore it has a much higher impact on the choice of action. The frame can be of varying strength (or "salience") relative to the background. Conflicting goals in the background weaken the frame's salience whereas congruent goals in the background strengthen it. The higher the salience, the more likely that the person will choose the alternative he ranked highest in this situation. Thus, when the frame is very salient, the entities in the background don't influence the choice of action at all and the person acts as if he had only one maximand (the goal state connected to the frame). The less salient the frame gets relative to the background, the more action will **also** be affected by entities in the background and this influence will show up in increasing probabilities of alternatives that stand lower in the ranking. The model has been successfully tested empirically in various studies (see for example Braspenning, 1992 and Ligthart 1995). It shares the focus on the selectivity of the information processing with concepts such as "mindset", "orientation", "frame of reference" but it puts more emphasis on the possible effects of the background goals and thereby on the precariousness of the frame in the face of competing goals.

The frame is determined by the "definition of the situation" which contains a goal that is more salient than all other possible goals in that situation and goal criteria (i.e. criteria that define successive approximations to the goal realization). Take as example that Fred, CEO of company A, is in a meeting with his staff discussing cost cutting measures when a call is coming in from Ralph, the CEO of company B. Ralph needs help desperately. Fred realizes right away that it is an emergency and he defines the situation vis-a-vis his friend Ralph as "a friend in urgent need". In that case, goals related to the meeting, and, importantly goals related to "not losing valuable resources (such as money, time or effort)", will be pushed into background. **Money to Fred is at that moment worth much less than a moment ago** when he was in the meeting focused on cost cutting measures. What is in the foreground is the goal to help an friend in urgent need and the goal criterion in this case might be that Ralph must also feel he is being helped by Fred's actions.

The friendship frame mobilizes appropriate chunks of knowledge, rules and criteria. For example, the legitimate amount of help (in terms of money, time and effort) for which Ralph can ask is roughly indicated by the strength of the friendship, the consequences for Ralph of not helping, etc. The opportunity costs for helping are not keenly perceived because they belong to goals in the background.

Technically, we can speak of a situationally variable marginal utility of goods. The

strength of this situational effect of marginal utility depends on the relative weight of the focal goal (the frame) to the background goals. If Fred's company had just lost a million dollars before Ralph contacted him about his problem, then the goal "not to lose valuable resources", though in the background, would be stronger and weigh down more heavily the salience of "helping a friend in need". A lower salience of the friendship frame would translate itself into a lower probability that Fred would go all out to help Ralph. In the extreme, the background goal could become so strong that it displaces the focal goal.

There is also a dynamic aspect involved. Helping depletes resources and increases the salience of the background goal "not to lose valuable resources". If the friend keeps coming back for more, then the background goal will become stronger and lower the salience of the frame "to help a friend in need" even if you are convinced that the friend's need is real. You may still help but you increasingly lower the amount (i.e. deviate more from the optimal amounts for friendship), and when you come into a situation where the salience of the frame approaches zero, i.e. when it gets close to a toss up whether you help or not, the frame is likely to switch to "watch your own finances". With the new frame, other alternatives come in with their own ordering, other knowledge chunks are being mobilized, and links to other kinds of situations come into view. You may regret not being able to see the friend as friend anymore when he turns up, to see him only as a drain on your finances. But, like all constraints, the frame itself cannot be chosen at will, only influenced over time, for example by trying to avoid situations which lower the salience of a particular frame.

Overarching frames. There are of course many goals people can pursue and there can be just as many frames. However, goals are generally hierarchically organized, which allows us to consider a few high-level goals each of which can become an overarching frame with many subgoals. I will mention three such overarching frames which are relevant for our analysis: gain frame, loss frame, and normative frame.

A **gain frame** is concerned with the resources. It is most typical of what people generally associate with rational choice. Gain as a goal is here defined in terms of increasing one's scarce resources, such as money, disposable time, marketable knowledge, marketable skills, decision power, social influence etc. Again, the kinds of knowledge chunks, beliefs, attention to situational aspects etc. that are being mobilized in a situation where gain is the overriding goal are specific to the task, the more so the more salient the frame. If somebody is asked for help, then a person in a gain frame will not mobilize beliefs about the general obligation to help or about the legitimacy of asking for help, but rather, say, beliefs about the possibilities of making a profit and the legitimacy of making the best of the situation for yourself.

Loss is not the same as negative gain. The asymmetry between losses and gains in terms of utility (when both are subjectively medium or large) seems to be well established (see Kahneman, Knetsch and Thaler 1991). Losses weigh heavier than gains. Gains are by and large less disruptive than losses and thus are less likely to be accompanied by a strong emotional response. The goal of a loss frame is to prevent or get rid of the feeling of loss. At times, gains are so firmly anticipated that not getting them feels like a loss, like a disruption after all expectations have already adapted to the increase in resources. This can particularly happen with so-called "golden opportunities" that suddenly arise and, if not taken advantage of right away, will vanish and leave the impression of loss, of a missed opportunity. It can easily be imagined, how such "golden opportunities" brought in by third parties can act like random shocks in an ongoing contractual relationship. The time horizon of a loss frame is short because the goal is strongly linked to emotions (see Loewenstein 1996).

Normative frame. Here, the goal is "to act appropriately", to "do the right thing". In our friendship example, a friend asking for help is likely to trigger an overarching normative frame with the subgoal "to help a friend in need". Given the friendship norms, helping a friend in need is the appropriate thing to do and there is an appropriate range for the amount of help that the friend can legitimately ask. Within that range, the cost of helping is not sharply calculated because it belongs to a goal in the background (say, the goal "to watch one's scarce resources"). Ligthart (1995) has demonstrated this influence of norms on frames experimentally. The frame also activates relevant knowledge chunks, criteria for judging the success of one's plan of action etc. The important point to make here is that the cost of conformity and the benefits of non-conformity are pushed into the background. There, they still have an effect but a much smaller one than in a gain frame in which it would be in the foreground. Experimental evidence demonstrates the effects of gain and normative frames on negotiations. For example, De Dreu and Boles (1998) found that individuals with a "social value orientation" (comparable to a normative frame) chose significantly more frequently "appropriateness" as their guiding goal for negotiation whereas individuals with a competitive value orientation (comparable to a gain frame) chose significantly more often "effectiveness" as their guiding goal for negotiation.

The suspension of opportunism

Considering the three overarching frames, it becomes clear that trust and mistrust have to do with the way these frames affect each other. **A normative frame suspends opportunistic behavior** proportionately to the salience of the frame. This is crucial for the placement of trust. In a longer-term business relation, I trust my business partner if I have reason to believe that as a business man he is in a gain frame but with regard to our relationship, he is in a normative frame and that this frame is quite stable in situations in which possible background goals might lower its salience and displace it. A normative frame has two potential enemies: first, the goal to increase one's scarce resources (gain); second, the goal to avoid feeling losses.

If we turn to the first goal (gain), we can see what the relationship is between trust and reducing mistrust. Blatant self-interest in economic contexts can be identified with gain. When gain is highly salient, it will displace a normative frame no matter how good the intentions are. **Legitimate mistrust** is the perceived likelihood that a potential or actual transaction partner's interests are not aligned with one's own interests and that the partner's actions are (and will be) driven by a salient gain frame such that relational and normative considerations are pushed into the background. The partner will be **strategically opportunistic** (i.e. willing to lie, cheat and generally harm the other) because restraints on that opportunism would come from goals that are so far pushed into the background that they will not affect the partner's actions. The salience of the gain frame has to be lowered first lest it keeps a normative frame from guiding the action with regard to the relationship. Thus, unless interests are aligned there is no possibility for the establishment of a business relationship in which a normative frame plays any important role. A normative frame for the ongoing business relationship must be "flanked" by interest aligning arrangements if it is supposed to have any stability at all. Removing cause for legitimate mistrust is thus a necessary condition for the establishment of trust. However, it is not a sufficient condition.

Once strategic opportunism has been removed, there are still the random shocks of situational temptations. They consist of sudden potential losses and golden opportunities,

both of which are likely to trigger a loss frame. In that case, the partner will be **myopically opportunistic**, responding to short-term temptations possibly against his longer-term interests. Myopic opportunism is especially likely where a normative frame (and thus trust) is especially needed: in situations in which monitoring contract performance in detail is costly. Trust will only be established if strategic **and** myopic opportunism are being checked. We have seen that much attention has been given in the literature to ways in which interests can be aligned, especially through credible commitments, in order to reduce strategic opportunism. How is myopic opportunism handled in the daily routines of longer-term contractual relationships?

The role of conventions

Frey (1997) showed that a gain frame can effectively “crowd out” a normative frame. It is much more difficult to keep a normative frame stable than a gain frame. The stability of their partner's normative frame is thus rarely taken for granted. Interestingly, people are also concerned about the stability of their own normative frame and this is mainly due to the effect of **loss** on framing. If a person experiences a loss, say due to uncooperative behavior of another, then the fact that losses quickly produce strong emotional reactions makes it likely that whatever frame a person is in, it will be replaced by a frame in which eradication of the feeling of loss is the focal goal. If nothing can be done to restore the loss, then "getting even" would be one way, although not a productive one, to balance things out. For example, Uzzi (1997, p.59) in investigating interfirm networks in the apparel industry found that "if the strong assumptions of trust and cooperation are exploited in embedded ties, vendettas and endless feuds can arise." A loss frame can be very destructive of both partners' resources. Uzzi reports a CEO as saying "If you screw a guy like that [a close tie] he'll stay in business just long enough to get even." (ibid.) Partners would like to avoid bringing another person into a loss frame when they have to confront the consequences. Thus they are interested in not "slipping" into uncooperative behavior via myopic opportunism and decay.⁸ **They are interested in their own frame stability.** This offers the possibility that the stability of normative frames is maintained by joint efforts rather than by controlling efforts of one partner over another.

The stabilization of normative frames is very likely not just done by the contracting dyad but by one or more larger groups of people who share similar kinds of random shocks and the common purpose of frame stabilization. These groups can be voluntary association of the industry, they can be lobbying organizations, country clubs, charities, religious organizations. The larger the random shocks of situational temptations, the more likely that such groups play a crucial role in frame stabilization for longer-term business relationships. Such random shocks are likely to differ by industry. Joint conventions for the detection of non-cooperative behavior are typically produced by such groups. A crucial question is: when has the other been myopically opportunistic? Take for example rules dealing with the identification of sources of disturbance. What disturbances are to be expected? What disturbances are extra-ordinary in a particular industry. Who is to blame for such disturbances? For example, if the production costs suddenly skyrocket and put pressure on price agreements, what conventional understandings are there to prevent both myopic opportunism and the misplaced suspicion of myopic opportunism? Similarly, there are conventions about quality and quality control, about sources of negative externalities, about the measurement of damages. It is knowledge of these convention which makes arbitration in conflicts so much

more important than courts, and Williamson, who does not identify any of these group processes, is at least right when he mentions arbitration as a means for "harmonious adaptations and preserving the continuity of exchange relations." (Williamson 1985, p.178).

The development of conventions is, like any other development of institutions, subject to collective learning and to path dependency. From an economic point of view, there could be "wrong" conventions. Let me briefly elaborate. It is not easy to consistently fake behavior as if it came from a different frame. A much greater danger is that the signals are not well calibrated given the distinctive features of the industry. For example, if the influence of typical mishaps in an industry is not taken into account in the conventions on relational signals, then business partners have to apologize for mishaps much too often to remain believable. Also, the maximum sacrifice expected for solidary behavior can be too high or too low. If it is too high, unwillingness to go that far will be (wrongly) interpreted as myopic opportunism, breaking relations were they did have a good chance to continue or keeping new relations from forming even if they were potentially profitable for both potential partners. If it is too low, the relational considerations will not be up to the typical difficulties of the industry. There will be too little mutual help, too little consideration when delivery is late, etc. In new industries, dysfunctional relational signals are likely to occur and it will take time to collectively create conventions on relational signals that have internalized the typical distribution of mishaps, of need situations, of windfalls and losses, etc. With technology changing fast, there is no longstanding industry-wide lore to depend on. Conventions must adapt quickly and that, in turn, may depend on existing networks and the input from economics (see for example Callon 1998).

Monitoring via relational signals

What precisely will the conventions be about? In order to answer this question, we have to look more closely at the stability of normative frames. Normative frames are precarious because they are subject to the barrage of competing frames. A strong normative frame will guarantee a cooperative attitude towards the partner when relational aspects are involved. But even when the central focus is on gain, the goal to act appropriately will lower the salience of the gain frame the more incompatible the action is with a relationally appropriate action. When the goal to behave appropriately weakens, the salience of the gain frame is lowered less or not at all. Then even a clever business man will give off involuntary signals that the relational concerns are not governed by a normative frame. For this reason, partners in longer-term business relations can economize on monitoring costs if they concentrate on signals that tell them something about the stability of the normative frame and thus about the trustworthiness of their partner (see also Wielers 1993). If this frame seems stable, they have little incentive to monitor performance itself unless there are situations where the performance is very telling with regard to frame stability. For the stability of normative frames there are five crucial telltale situations all of which involve some sacrifice and which can be jointly called "solidary behavior". Let Ego and Alter be the business partners.

Common good situation. Ego and Alter both belong to a group that produces a common good. Ego will contribute to the common good even if he could freeride (the minimal amount of contribution in terms of money, effort, time etc. expected for solidary behavior varies)⁹.

Sharing situation. If there are joint divisible benefits and costs and if Ego is the one who can divide them, he will not seek to maximize what he gets from the benefit and minimize what he gets from the costs but take his "fair share" of both (what the "fair share" is varies).

Need situation. Ego will help Alter in times of need (what constitutes need and how much help is minimally expected for solidary behavior varies).

Breach temptation. Ego will refrain from hurting Alter even at a cost to himself (the minimal amount of cost expected for solidary behavior varies).

Mishap situation. Acts can be intendedly solidary but factually turn out to go against the expectation of solidary behavior. In that case, Ego will show that he meant to act differently, that he feels sorry that it turned out that way, and he will make amends if the mishap has caused damage to others. Also if Ego knows in advance that he will not be able to keep to the agreement, he will warn others in advance, so that they can mitigate the damage.

Observe that since behavior in these five situations signals the stability of the normative frame (and thus the trust worthiness) of the partner, there can be no substitution between these situations. A partner cannot make up for having given in to a breach temptation but helping in need because the help will be interpreted as coming from a gain frame, as being an attempt to appear as if a normative frame still reigned.

Behavior in these five situations is important in itself for any joint project. However it is equally important for the **relational signals** it gives off. As long as these signals are all positive, the normative frame is stable. This allows the partners to monitor other contractual behavior via these relational signals. If they are "o.k.," one does not have to keep checking the quality, does not have to keep counting the quantities etc. Conventions thus focus first and foremost on the functioning of relational signals, prominently including the "right" level of sacrifice in each of the five solidarity situations. When relational signals don't function properly, trust cannot develop or be maintained, no matter what the written contracts look like.

In a recent study of the better dress sector of the apparel industry in New York, Uzzi (1997) made a distinction between "arm's-length ties" (market relationships) and "embedded ties" (close or special relationships). The apparel industry contains simultaneously market and embedded relations, the former being a majority, the latter being the relations of special importance. Individuals (contractors, manufacturers, production managers etc) would behave blatantly with self-interest in the market and cooperatively in the embedded relationships. His detailed findings point clearly in the direction of relational signals in these five telltale situations. The embedded relations developed over a longer time and showed typically solidary behavior in the five situations. The profitability for each was seen as a **common good**. "We are all in the same boat" Uzzi reports a contractor as saying. Uzzi found that extra effort was voluntarily given and reciprocated, there was joint problem solving, much communication and a very quick understanding of what adjustments had to be taken. There also was signaling in **sharing situations**, even going as far as post hoc pricing. As one CEO put it "we do first and fix price after" or another CEO would say "the contractors know that they will not lose." Help in **need situations** was taken for granted: "If there was a problem you knew you'd work it out and they'd help you" said a manufacturer of 30 years experience. By contrast, in arm's length relationships the other would "push the price down when the contractor tells his production problems." It was also evident that **breach temptations** are not generally taken advantage of. He reports that there is nondefection where defection clearly would serve the self-interest of a business partner. But then, there is also a watchful eye. Too frequent need

situations are under suspicion of being covert breaches, putting the partner on the alert. Clear breaches are not forgiven. "If he switches to a new contractor then I won't work with that manufacturer again." Contrast this to **mishap situations**. A manufacturer expressed it thus: "When you deal with a guy you don't have a close relationship with, it can be a big problem. Things go wrong and there's no telling what will happen. With my guys [his key contractors], if something goes wrong, I know we'll be able to work it out."

In a recent study, comparing Japanese and American companies, Muhlau (2000) could show that, when relations are important, governance structures function mainly by clear relational signals from employers to employees. This holds for wages, for promotions, and generally for governance by fair rules. When relations are not deemed important enough by the employer that he would consistently meet relational expectations, employers take extra steps to prevent the development of relational expectations on the side of the employees. Informal rules also are subject to relational signaling. For example, Wittek (1999) found that informal control strategies in organizations can best be explained by how control affects relational signals.

Buildup and limits to relational concerns

Even if there is no need to mistrust the partner, trust is established slowly because there must be occasion to observe relational signals over time. This necessitates occasions for the partner to give off negative relational signals. It takes time and frequent occasions for each of the five situations arise. For this reason alone, one would expect the shadow of the past of an active business relation to have a strong impact on trust, more so than prospect of a future business relationship. Findings by Blumberg (1998) confirm this asymmetry between past and future in interfirm contracting.

There are situations when there is not time for this build-up, where "swift" trust is required because the task requires instant high-level cooperation. Examples are making movies and organizing Olympic Games. How can trust arise in these situations? There has been very little research on the matter yet, but there are some hints. Meyerson, Weick and Kramer (1996) suggest that there must be very special circumstances for such swift trust to materialize. The goods to be jointly produced must be of a certain kind: high stakes, high skill-level (easily recognized or reputation based), and moderate levels of interdependence (leaving considerable control over actors' own contribution). Just how relational signals develop is not quite clear but it should be noted that conventions about relational signals can cumulate even in temporary organization if the tasks are basically comparable across projects. Swift trust stresses rather than distracts from the importance of such conventions.

There is also the other side of the coin. A normative frame that is too strong can crowd out a gain frame. Relationships can be a blessing but they can also be too restraining. This point is related to the what has been said about quality of conventions. For example, there can be times in which the maximum sacrifice expected in any of the five solidarity situations increases due to external threats to the company or even the industry in a business relationship. People then feel they have to close ranks against the state, against the competition, against imports from abroad, against a regulatory authority etc. If such pressures to close rank remain active for a longer time, they can create rigid conventions that don't easily adapt to changing times and the need for lower sacrifice levels for relational signals.

For example, the famed Japanese **keiretsu** (see Gerlach 1992) may have turned out too rigid in recent times. Uzzi (1997) also reports the possibly stifling influence of some close business relationships in the apparel industry in New York. Intergroup relations in organizations often show similar problems of rigid ingroup conformity pressures, creating polarization between groups (see Kremer 1991).

6. Conclusion

It is crucial what question one brings to the analysis of contracts. If it is the questions whether optimal contracts can be written, then it is not necessary to go into any analysis of trust. Calculated risk will do. If, however, one is interested in the **contractual relationship**, the emphasis changes. The contract itself is now one part of the contractual relationship and, in fact, it is to be understood as part of that relationship. Should one be interested in contractual relationships? The answer depends on the presumed ability to anticipate possible trouble and to take care of it in the contract here and now. How far does the assumption “that economic actors have the ability to look ahead, discern problems and prospects, and factor these back into the organizational/contractual design” (Williamson) go? If the incompleteness of the contract is taken to be endemic whenever complexity is more than minimal, in other words if we cannot even assign probabilities to all the outcomes because we don't know the menu of possible outcomes, then the **ex post** part of the contract, the ongoing contractual relationship, should be the major concern for contractual analysis. The **ex ante** part is then to be analyzed in terms of the role it plays **ex post**.

It is argued that if we are interested in contractual relationships, then the problem of trust should be looked at from two sides at the same time: the side of mistrust and the side of trust. The reason for this is that the instruments needed to reduce mistrust are different from those needed to build and maintain trust. What's more, trust cannot be built and maintained if mistrust is not considerably reduced. This links both phenomena and therefore they should not be seen as substitutes. Both warrant close study. The calculated risk approach is useful for the analysis of situations in which potential business partners do not come to an agreement because they legitimately mistrust each other. Mistrust is legitimate if foreseeable and blatant self-interest runs against keeping to the agreements. The solution to legitimate mistrust problems is interest alignment through credible commitments, such as hostages, through reputation effects, middlemen, and other means. Once legitimate mistrust problems have been (largely) removed, contracts can and in all likelihood will be entered. These aspects have been studied quite well by economists and rational choice sociologists. Strategic opportunism can be checked by interest alignment.

Most interesting contractual situations for which mistrust problems arise are also potentially longer-term contractual arrangements. During such longer-term relations many occasions arise in which there are unforeseeable temptations to cheat or deviate in some way from the contractual agreements. Such temptations are called **myopic opportunism**. They do not derive from generally misaligned incentives but from random shocks that cannot be anticipated *ex ante* and that do not give rise to mistrust simply because interests have by assumption already been aligned (taking care of strategic opportunism). Even though giving in to these temptations may be against the own longer-term interest, it happens time and again that people fall prey to such temptations when "golden opportunities" arise or when difficul-

ties render cutting corners temporarily attractive. An approach that only considers farsighted contracting (as for transaction cost economics), these problems of "myopic opportunism" cannot even be described let alone analyzed.

Myopic opportunism creates genuine trust (as opposed to mistrust) problems. The central question is: How and under what conditions can people be relatively confident that the other will not give in to myopic opportunism? And what do people do in various circumstances in order to achieve this confidence? The principle guiding the answer is: if people do not pay much attention to short-term opportunities to breach, then they will be trusted and are trustworthy. The cognitive mechanism (framing) by which this is possible is quite well understood. If I can monitor my business partner's frame, I know whether or not he is likely to give in to myopic opportunism. The paper describes how this monitoring is possible. The partner's behavior is taken as so many relational signals that are difficult to fake and reveal the frame the partner is in. The working of these signals is subject to conventions developed in larger groups (often industries). They are quite crucial to the functioning of an ongoing contractual relationship. Due to path dependencies, they can at times stifle business relations. Well-functioning conventions on relational signals cannot be taken for granted. For this reason, it is argued that the study of these conventions is taken to be an integral part of studying contractual relationships.

NOTES

¹ For example, Richter (2000, p.8) points to the fact that the assumed information the principal has to have in order to overcome asymmetric information regarding his agent is considerable.

² In Richter (2000) these kinds of puzzles are not being discussed.

3. See Raub and Weesie 1990.

4. See Casson 1991.

5. DiMaggio and Power, however, fail to identify the choice from the menu of governance instruments as a remedy against legitimate mistrust. Rather, they see the choice only as a means to legitimate one's own organizational form.

6. See Buskens 1999, Gal 1997, Klein 1997, Landa 1994, Raub and Weesie 1990, Snijders 1996.

7. Because the term "attention" is highly ambiguous (see Pashler 1998). I avoid it and speak instead of "framing". But notice that the term "framing" as used here differs from many other uses of this term. The framing theory used here is a stochastic theory of choice in which the choice probabilities depend of the relative strength of the frame. I will not go into any technical exposition here.

8. This point as been worked out in some more detail in Lindenberg 1994.

9. A prisoners' dilemma could be seen as either a common good situation or as a breach temptation, depending on the particular interpretation given to the story.

BIBLIOGRAPHY

- Bargh, J.A., [1984], "Automatic and conscious processing of social information." pp. 1-44 in Vol. 3 of R.S. Wyer, Jr. and T.K. Srull (eds.), Handbook of Social Cognition. Hillsdale, NJ: Erlbaum
- Blumberg, B. 1997. Das Management von Technologiekooperationen. Amsterdam: Thesis Publishers
- Bodenhausen, G.O. and Macrae, C.N. 1998, "Stereotype activation and inhibition", pp.1-52 in R.S. Wyer (ed.), Stereotype Activation and Inhibition. Advances in Social Cognition 11, Mahwah, NJ: Lawrence Erlbaum.
- Braspenning, Jozé, Framing: de prospecttheorie en het discriminatiemodel, Groningen, 1992
- Buskens, V. (1999). Social Networks and Trust. Amsterdam: Thela Thesis
- Callon, M. (1998), "Introduction: the embeddedness of economic markets in economics". Pp.1-57 in M. Callon (ed.), The Law of the Markets. Oxford: Blackwell Publishers
- Carnevale, P.J.D. and Lawler, E.J. (1986), "Time pressure and the development of integrative agreements in bilateral negotiations". Journal of Conflict Resolution, Vol. 30: 636-659
- Casson, M. (1991), The Economics of Business Culture. Oxford: Clarendon Press
- Coleman, James S. (1990), Foundation of Social Theory. Cambridge, Mass.: Harvard University Press.
- Dasgupta, P. (1988), "Trust as a commodity." pp.49-72 in: D. Gambetta (ed.). Trust: making and Breaking Cooperative Relations. Oxford: Blackwell
- De Dreu, C.K.W. and Boles, T.L. (1998), "Share and share alike or winner take all?: The influence of social value orientation upon choice and recall of negotiation heuristics". Organizational Behavior and Human Decision Processes, Vol. 76:253-276
- DiMaggio, P.J. and Powell, W.W. (1991), "The iron cage revisited: institutional isomorphism and collective relativity in organizational fields," pp.63-82 in: W.W. Powell and P.J. DiMaggio (eds.), The New Institutionalism in Organizational Analysis. Chicago University Press: Chicago
- Fazio, R.H. (1990), "Multiple processes by which attitudes guide behavior". Advances in Experimental Social Psychology, Vol.23:75-109
- Frey, Bruno S. (1997). Not Just For the Money. An Economic Theory of Personal Motivation. Brookfield: Edward Elgar Publishing
- Gál, R. (1997). Unreliability: Contract Discipline and Contract Governance Under Economic Transition. Amsterdam: Thesis Publishers.
- Gerlach, M.L. (1992), Alliance Capitalism: The Social Organization of Japanese Business. Berkeley: University of California Press
- Gollwitzer, P.M. and Moskowitz, G.B. (1996), "Goal effects on action and cognition". Pp.361-399 in E.T. Higgins and A.W. Kruglanski (eds.), Social Psychology Handbook of Basic Principles. London: The Guilford Press
- Higgins, E.T. and Brendl, M. (1995), "Accessibility and applicability: some activation rules

- influencing judgment". Journal of Experimental Social Psychology, Vol. 31: 218-243
- Kahneman, Daniel, Jack L. Knetsch, and Richard H. Thaler (1991), "Anomalies: the endowment effect, loss aversion, and status quo bias." Journal of Economic Perspectives, 5:193-206
- Klein, D.B. (ed.) (1997), Reputation: Studies in the Voluntary Elicitation of Good Conduct. Ann Arbor, MI: University of Michigan Press
- Kramer, R.M. (1991), "Intergroup relations and organizational dilemmas". Pp. 191-228 in B.M. Staw and L.L. Cummings (eds.), Research in Organizational Behavior, Vol. 13. Greenwich, CT: JAI Press
- Kruglanski, A.W. (1996), "Motivated social cognition: principles of the interface." Pp.493-520 in E.T. Higgins and A.W. Kruglanski (eds.), Social Psychology Handbook of Basic Principles. London: The Guilford Press
- Landa, J.T. (1994), Trust, Ethnocentricity, and Identity. Ann Arbor, MI: University of Michigan Press
- Ligthart, P.A.M. (1995), Solidarity in Economic Transactions: An Experimental Study of Framing Effects in Bargaining and Contracting. Amsterdam: Thesis
- Lindenberg, S. (1988), "Contractual relations and weak solidarity: the behavioral basis of restraints on gain-maximization", Journal of Institutional and Theoretical Economics/ ZfgS, 144, 39-58
- Lindenberg, S., (1993), "Framing, empirical evidence, and applications", pp. 11-38 Jahrbuch für Neue Politische Ökonomie. Tübingen: Mohr (Siebeck)
- Lindenberg, S., (1994) "Norms and the power of loss: Ellickson's theory and beyond." In: Furubotn, E.G. and Richter, R., (eds), The New Institutional Economics. Bounded Rationality and the Analysis of State and Society. Special Issue of the Journal of Institutional and Theoretical Economics, 150/1, p.101-113
- Lindenberg, S. and Frey, B. (1993), "Alternatives, frames, and relative prices: a broader view of rational choice". Acta Sociologica, 36, 1993:191-205
- Loewenstein, G.F. (1996), "Out of control: visceral influences on behavior." Organizational Behavior and Human Decision Processes. Vol. 65,3:272-292
- Loewenstein, G.F. and Elster, J. (ed.) (1992), Choice over Time. New York: Russell Sage
- Loewenstein G.F. and Thaler, R. (1989), "Anomalies: Intertemporal choice." Journal of Economic Perspectives,3,:181-193
- Macneil, I. R. (1978), "Values in contract: internal and external," Northwestern University Law Review, 78, 340-418
- Meyerson, Debrah, Weick, K.E. and Kramer, R.M. (1996), "Swift trust and temporary groups". Pp.166-195 in: R.M. Kramer and T.R. Tyler, Trust in Organizations. Thousand Oaks: Sage
- Pashler, H.E. (1998), The Psychology of Attention. Cambridge, MA: MIT Press
- Raub, W. and Weesie, J. (1990), "Reputation and efficiency in social interactions: an example of network effects". American Journal of Sociology, 96
- Richter, R. (2000), "Verträge aus wirtschaftstheoretischer Sicht". This volume
- Rousseau, Denise M., (1995), Psychological Contracts in Organizations. Understanding Written and Unwritten Agreements. Thousand Oaks: Sage
- Snijders, C. 1996, Trust and Commitments. Amsterdam: Thela Thesis

- Tyler, T.R. and Kramer, R.M. (1996), "Whither trust?" pp.1-15 in: R.M. Kramer and T.R. Tyler, Trust in Organizations. Thousand Oaks: Sage
- Uzzi, B. (1997). Social structure and competition in interfirm networks: the paradox of embeddedness. Administrative Science Quarterly 42,1:35-67
- Wielers, R. (1993). On trust in employment relationships: the case of child-minders. Netherlands' Journal of Social Sciences, 29: 43-63
- Williamson, Oliver E. (1975), Markets and Hierarchies: Analysis and Anti-Trust Implications. New York: Free Press.
- Williamson, O.E. (1985), The Economic Institutions of Capitalism. New York: Free Press.
- Williamson, O.E. (1993). Calculativeness, trust, and economic organization. Journal of Law and Economics, Vol. XXXVI, 453-486
- Witteck, R. (1999), Interdependence and Informal Control in Organizations. Amsterdam: Thela Thesis